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CO-INVESTMENTS

Sharing isn't always easy

Today almost every GP is obliged to provide at least some co-investment deals to investors. Debevoise & Plimpton's Katherine Ashton outlines the issues at stake

Ashton: *club deals are on the wane*

With so much demand for co-investment on the part of investors, and so many promises of opportunities from fundraising sponsors, there is a growing sophistication in execution. Here, Katherine Ashton, partner at the law firm Debevoise & Plimpton in London, tells *Private Equity International* what she is seeing in terms of issues and resolutions.

Q Why are co-investments now happening with greater frequency?

Firstly, club deals, where PE firms band together sharing governance as well as money, are on the wane. There have been a lot of not particularly successful deals, and it is time consuming and difficult to negotiate the governance around who makes the decisions. That means sponsors that want to invest in large deals are increasingly likely to favour relatively passive co-investors.

Second, we have reached a point where the co-investment rights that LPs have been demanding as a price for coming into primary funds are coming to fruition. In recent years, those became a standard request, and today almost every GP has some obligation to show co-investment deals to some investors. For LPs, these deals represent a way to diversify and show some great returns.

Q What are sponsors' motives in bringing in co-investors? And are pre-closing or post-closing opportunities more common?

The question is whether the sponsor is offering the opportunity just because they promised they would or because they genuinely want to lay off part of the expense and the risk. Both motivations are common, but they affect the dynamic and the process.

Sometimes there are a number of co-investors who all want more of the deal than they are getting. In those cases, the LPs that do well are the ones who work well with the sponsor and make the effort to understand the dynamics and the timetable of the underlying transaction. Other times there is one LP with a significant piece of a large deal.

Ten years ago, sponsors would do deals and then afterward look to lay off part of the risk by bringing in co-investors and syndicating out pieces. That still happens, but now it's much more common for LPs to be brought in earlier by the sponsor, before the deal has closed. Then there is a lot more time pressure, but there's also more opportunity to potentially influence the structure.

Q Do co-investments work better for specific types of LPs? Are there new entrants coming into the market?

Not all the LPs doing deals are traditional private equity players. We see sovereign wealth funds, and new entrants including institutional investors from other parts of the world, who may be interested in the direct dealflow and exposure that co-investments offer but are not always set up to make decisions as quickly as sponsors need them to.

On the other hand, a sovereign wealth fund may have so much money and so much potential influence with the sponsor that it can participate in a very meaningful way and materially impact transactions. It's all about relationships – there aren't a lot of structural barriers to coming in and doing co-investments; it is whether you can persuade the sponsor to give you a piece of the action. Sponsors are wary not only of the reputation of the LP, but also of the risk that something goes wrong in the future with the investment and the sponsor may need to work with that investor to put in additional capital or restructure the deal.

Q How do LPs react to sponsor contacts undertaking co-investments with other (potentially rival) LPs?

I have not come across that as a major issue. Yes, there is competition, because LPs are quite often scaled back and get less of the deal than they want. But everyone acknowledges sponsors have numerous demands and LPs need to distinguish themselves by being easy to work with.

Co-investments are significant transactions and need to be taken seriously. But they are a different kind of negotiation, because it's not winner takes it all in the way it is when negotiating M&A. Instead, these deals are driven by long-term relationships – the parties already do business together in lots of different ways and want to do business together again.

Q What structuring aspects of a co-investment spark the most debate between LPs and GPs?

If you're going into a deal pre-closing, then an important issue is what happens if the deal doesn't close – how do you split up expenses, for example, and also what ability does the sponsor have to force the co-investor's hand if the terms change a little.

Once you get through the deal, the most important thing is the governance and structuring arrangements by which the co-investor is brought in. When representing an LP, you have to look carefully to make sure the interests of the LP continue to be aligned with the interests of the sponsor, so the sponsor cannot dilute the LP by putting more money in, for example. If the sponsor decides to sell, the co-investor should be able to go along.

If you're an LP, you want to go into a deal with the understanding that you will make or lose money to the extent that the sponsor does, so you want to make sure the legal structure allows for that and that will continue to be the case down the road.

Q To what extent are major institutional investors turning to co-investment opportunities instead of commitments to more traditional fund vehicles? Could the co-investment model overtake traditional funds?

In our experience of the market today, there are a lot of people with a lot of money to invest, and it is not a zero-sum game of one or the other. For most major investors working with fund sponsors that they trust and have done well by, there's an eagerness to have more direct exposure to the magic value that a really good sponsor can bring.

It is about diversifying and coming up with a bespoke solution. If you are an LP investor with a really great sponsor and you need more exposure to, say, Southern Europe, then co-investment is a great way to pick and choose and construct a portfolio more attuned to your assessment of the market.

Q What are the risks of co-investments?

As an LP, you are piggy-backing on a sponsor. So, although you may have some opportunity to do due diligence and structuring, in essence you are trusting the sponsor not only to identify a good opportunity, but also to get the right price and manage that investment through to a good exit and a good return. The co-investor gets to tailor its portfolio, but it may end up very exposed to one manager.

> ***"There's an eagerness to have more direct exposure to the magic value that a really good sponsor can bring"***

Some co-investors may not have the background and resources to adequately appraise an opportunity – the best ones don't just work very well with GPs, but are also rigorous in their analysis and know when to say no.

From the sponsor point of view, the risk is that you bring other people into your situation, and if something goes wrong they complain. Plus, there is the execution risk of bringing them in, and, in theory, the highly unlikely but terrible scenario where a sponsor may have committed to pay X, the co-investor agrees to pay Y, and then the co-investor defaults and the deal collapses.

Sponsors today are moving toward standardising their co-investment documentation as much as they can because nobody wants to be dealing with the same issues over and over again when bringing in more parties to a deal. The bigger sponsors are increasingly working to make it more cookie-cutter deal-to-deal, and I think that standardisation will continue as the co-investment market continues to mature. ■